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TAGS: EFIN ECON PGOV EINV KCOR BU
SUBJECT: BULGARIA TO INTRODUCE FLAT INCOME TAX

¶1. (SBU) SUMMARY: Bulgaria's center-left government approved the introduction of a flat 10 percent income tax on July 29. This move, largely unexpected from a socialist-dominated government, aims to boost domestic economic activity, stimulate investment, and curb the grey economy. Business organizations and economists hailed the decision, calling it "a fiscal revolution," while trade unions voiced concerns about its impact on the poor. At the same time, the government also approved its second pension hike of the year, a move clearly aimed to please the Bulgarian Socialist Party (BSP) base ahead of local elections scheduled for October 28. END SUMMARY

FLAT 10 PERCENT INCOME TAX

¶2. (U) On July 29 the Socialist-led ruling coalition, which also includes the National Movement Simeon II (NMSS, soon to be called the National Movement for Stability and Progress) and the predominantly ethnic-Turkish Movement for Rights and Freedoms (MRF), voted to introduce a flat 10 percent tax rate for personal income. The current income tax rate ranges from 20 to 24 percent. After expected approval by Parliament in the fall, the new tax rate will come into effect January 1, 2008. The introduction of the flat income tax comes on the heels of a similarly radical reduction of the corporate tax rate to 10 percent, which came into effect at the beginning 2007.

¶3. (U) The aim of the flat tax is to stimulate investment, improve the business climate and curb the informal sector, which is officially estimated at 10-12 percent of GDP, but which is widely believed to account for 20-30 percent of economic activity in the country. The GOB is also aware it faces stiff competition for foreign investment from other East European countries in the EU and even from neighbors Romania, Serbia, and Macedonia, which have already instituted flat corporate and income taxes. With this in mind, the government also decided to cut employers' social contributions by three percent beginning October 1, a move strongly praised by business.

¶4. (SBU) Katia Koleva, deputy head of the National Revenue Agency and a Socialist Party official, told us that with anticipated increased compliance with a flat tax, tax revenue is expected to rise by 43 million leva (USD 30 million) next year. In addition, she noted the flat tax would significantly simplify her agency's examination duties, allowing the revenue agency to focus more on collection control and monitoring which, in turn, will curb the "grey" economy. Koleva lamented, however, that the government did not adequately plan the public roll-out of the tax cut. She said her party now needed to explain the social consequences of the flat tax -- widely perceived as a "rightist" tax policy approach favoring the wealthy -- to its traditional constituencies.

THROWING A BONE TO THE BASE

¶5. (U) Also on July 29, the ruling coalition approved a 10 percent hike in pensions as of October 1, 2007. This is the second such move this year. The new increase, totaling 100 million leva (USD 70 million), will be covered by a budget surplus which stands at two billion leva (USD 1.4 billion) so far this year. The pension hike is largely seen as a BSP populist move to please its core electorate ahead of October 28 local elections.

¶6. (SBU) Insiders tell us that Finance Minister Plamen Oresharski, a center-right financier known for his conservative fiscal stance,

did not favor the pension increase. He reportedly warned against attempting to "mix center-right measures with leftist populism" and urged the BSP to be more consistent with its economic policies.

STEALING A PAGE FROM THE OPPOSITION

¶7. (SBU) News of the flat tax brought predominantly positive reactions from both the business community and economists. Business has seen the flat tax as a tool for boosting economic activity and improving the business climate, while leading to higher growth in labor productivity. Krassen Stanchev, of the Institute for Market Economics (IME), a long-time proponent of the flat tax and former adviser to the opposition, noted with irony the fact that a socialist-led government had nearly "removed IME's raison d'etre" with the introduction of the tax. The center-right opposition parties, whose economic platforms envision the introduction of such a tax, criticized the decision as belated and said the government could have reduced social insurance payments even further. Trade unions in Bulgaria expressed concerns about the regressive nature of the flat tax and its effects on lower income workers (i.e., relieving higher earners of a greater tax burden).

EXCISE TAX TO GO UP AGAIN

¶8. (U) To offset any potential revenue risks of the tax cut, the GOB decided to increase excise taxes on tobacco (by 33 percent), coal (25 percent), electricity (16.7 percent) and fuels (7.8 percent) next year. These excise taxes will be raised again in 2009 in order to reach EU averages. The excise tax increase is expected to contribute mildly to inflation in 2008.

¶9. (SBU) COMMENT: By implementing this bold idea, first raised in Bulgaria by reform-minded financiers ten years ago, the BSP-led government has taken over one of the main economic initiatives of the struggling center-right opposition. The move is likely to boost economic activity and bring more businesses and employees into the legitimate economy. From a macroeconomic standpoint, the combined tax decrease and pension increase could increase household income. That, in turn, may put additional upward pressure on domestic price

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levels next year. Persistent inflation (7.3 percent in 2006) is holding back Bulgaria's efforts to join the Euro zone. The tax cut may also increase consumption, further aggravating the current account deficit (15.8 percent in 2006), the country's most pressing macroeconomic concern.

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